

STATE OF MICHIGAN
STATE OFFICE OF ADMINISTRATIVE HEARINGS AND RULES
FOR THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter of the complaint of)	
Barbara A. Bates against)	Case No. U-16009
DTE Energy Company.)	
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NOTICE OF PROPOSAL FOR DECISION

The attached Proposal for Decision is being issued and served on all parties of record in the above matter on December 6, 2010.

Exceptions, if any, must be filed with the Michigan Public Service Commission, P.O. Box 30221, 6545 Mercantile Way, Lansing, Michigan 48909, and served on all other parties of record on or before January 3, 2011, or within such further period as may be authorized for filing exceptions. If exceptions are filed, replies thereto may be filed on or before January 18, 2011. **The Commission has selected this case for participation in its Paperless Electronic Filings Program. No paper documents will be required to be filed in this case.**

At the expiration of the period for filing of exceptions, an Order of the Commission will be issued in conformity with the attached Proposal for Decision and will become effective unless exceptions are filed seasonably or unless the Proposal for

Decision is reviewed by action of the Commission. To be seasonably filed, exceptions must reach the Commission on or before the date they are due.

STATE OFFICE OF ADMINISTRATIVE
HEARINGS AND RULES
For the Michigan Public Service Commission

Sharon L. Feldman
Administrative Law Judge

December 6, 2010
Lansing, Michigan
drr

STATE OF MICHIGAN
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PROPOSAL FOR DECISION

I.

PROCEDURAL HISTORY

This Proposal for Decision (PFD) addresses the June 22, 2009 complaint of Barbara A. Bates against DTE Energy Company (Detroit Edison). In her complaint, Ms. Bates alleges that Detroit Edison made several changes in its accounting in 2008 and 2009 in violation of the Commission's order in Case No. U-15244 and good accounting practices.

The Commission issued a notice of hearing on September 1, 2009. Detroit Edison filed an answer to the complaint on September 16, 2009, denying any wrongdoing. Attorney General Michael A. Cox filed to intervene on September 18, 2010. Ms. Bates, Detroit Edison, Staff and the Attorney General appeared at the prehearing conference, held on September 24, 2009, and agreed on a schedule.¹ Following the agreed-upon schedule, Ms. Bates filed testimony and exhibits in support

¹ No party objected to the Attorney General's intervention, which was granted.

of her complaint on January 4, 2010; Detroit Edison filed testimony and exhibits on March 4, 2010; Ms. Bates filed rebuttal to Detroit Edison's testimony on April 5, 2010; Staff filed testimony and exhibits on July 1, 2010; Detroit Edison filed rebuttal testimony and Ms. Bates filed supplemental rebuttal testimony on August 4, 2010. The Attorney General did not file testimony.

At the September 8, 2010 hearing, the testimony of all witnesses was bound into the record by agreement of the parties without the need for the witnesses to appear. The witnesses were Ms. Bates, on behalf of herself, Theresa Uzenski and Jodi Frisicaró on behalf of Detroit Edison, and Kevin Liu and Brian Welke on behalf of Staff. The parties also agreed to the admission of all prefiled exhibits, as well as additional exhibits as reflected in the transcript, and to official notice of Detroit Edison's filing in Case No. U-16246.² In total, 33 exhibits were admitted in evidence. All testimony is transcribed in one volume.

Briefs and reply briefs were filed by all parties in accordance with the established schedule on October 7 and 29, 2010, except that the Attorney General did not file an initial brief, only a reply brief.

II.

POSITIONS OF THE PARTIES

A brief overview of the positions of the parties, with background information regarding the dispute and key portions of the record, is presented below.

² See Tr 64.

A. Barbara Bates

Ms. Bates worked as a financial analyst in various positions at Detroit Edison from sometime in 1998 until Detroit Edison terminated her employment on May 18, 2009.³ Her professional education includes a B.A. degree in Accounting and an M.S. degree in taxation. During her employment at Detroit Edison, she received several promotions, and her final position was Principal Financial Analyst assigned to the Distribution Operations area of Detroit Edison. Ms. Bates contends that she was terminated after she brought her concerns regarding Detroit Edison's accounting to the attention of her supervisors.⁴

While her complaint and testimony include additional allegations, Ms. Bates's briefs divide her concerns with the company's accounting into three general issues. First, Ms. Bates contends that Detroit Edison made several changes to its accounting methods related to the restoration and line clearance trackers approved in Case No. U-15244, and that these changes were prohibited by the rate case order and/or were otherwise unreasonable and imprudent.⁵ Second, Ms. Bates contends that the company treated revenues received to cover shared pole maintenance costs as Other Income and Deductions, while treating the expenses associated with that maintenance as an O&M expense. And third, Ms. Bates contends that beginning in April 2007, the company put in place dual accounting systems that resulted in double-allocation of certain capital line work expenses to Other Income and Deductions.

³ See Tr 29-30.

⁴ Ms. Bates presented direct, rebuttal and supplemental rebuttal testimony at Tr 29-62.

⁵ See Bates Initial Brief, pages 2, 36.

Ms. Bates believes that these changes were generally made to improve the company's recovery of costs under the tracker mechanisms, and/or to improve its income.

B. Detroit Edison

Detroit Edison denies any violations of the Commission's order in Case No. U-15244, or any material error in its accounting practices. Detroit Edison contends in response that Ms. Bates was fired for poor performance. Detroit Edison put Ms. Bates on a sixty-day "Performance Improvement Plan" on March 2, 2009, which would have concluded on May 2, 2009, sixteen days before her termination.⁶

Detroit Edison denies that its employees were aware of any concerns Ms. Bates had regarding its accounting practices prior to her termination. The company says that it first learned of Ms. Bates's concerns with the company's accounting practices after her termination, when it received a call from her attorney. At that time, the Audit Services group at Detroit Edison, referred to frequently as "AS", began an investigation pursuant to its investigation protocols. Subsequently, Detroit Edison received the complaint initiating this case, and broadened the scope of its internal investigation.⁷

Exhibit C-1, which is also Exhibit DE-3, is the Final Investigation Report written by General Auditor James F. Tompkins and Audit Manager Jodi Frisicaró. As indicated above, Ms. Frisicaró was one of the witnesses testifying on behalf of the company.⁸ She has an undergraduate degree in Business, and is a C.P.A. The report describes in

⁶ See Frisicaró, Tr 108.

⁷ See Frisicaró, Tr 104-108.

⁸ Ms. Frisicaró's direct testimony is at Tr 101-130.

some detail the procedures the audit committee undertook. The executive summary of the report summarizes its findings as follows:

AS found no credible evidence to support allegations of material misstatement of the financial statements (past or current). AS found no credible evidence of fraudulent activity. Certain of the former employee's factual statements were found to be correct, while others were found to be incorrect. AS did find immaterial errors and in one case, the Company was, prior to the MPSC Complaint or our investigation, already working to correct an immaterial error related to one of the allegations made by the former employee. We found no reason that the Audit Committee, management, or the external auditors should not rely upon certifications and representations of relevant management.⁹

Detroit Edison's other witness, Ms. Uzenski, Manager of Regulatory Accounting for the company, also testified regarding the accounting changes and concluded that they had no impact on ratepayers.¹⁰ Her undergraduate degree is in accounting and she has an MBA degree.

Detroit Edison emphasizes that Ms. Bates as the complainant bears the burden of proof in this proceeding. It acknowledges several of the accounting changes cited by Ms. Bates, but contends that these changes are not changes in accounting methods, but were permissible changes in accounting estimates required by Generally Accepted Accounting Principles (GAAP), that any misclassification of costs was unintentional and immaterial and had no effect on Detroit Edison's customers, and Detroit Edison did not attempt to hide data from or misrepresent financial information to the Commission.¹¹

Detroit Edison argues that the complainant presented no evidence that the accounting changes were made for any improper purpose or in violation of the Commission's order

⁹ Exhibit C-1, page 3.

¹⁰ Ms. Uzenski's direct and rebuttal testimony is at Tr 80-98.

¹¹ See Detroit Edison Brief, page 4, Detroit Edison Reply Brief, page 2, Tr 94, Exhibit DE-3, pages 24-25.

in Case No. U-15244 or any other legal constraints on the company's accounting. Detroit Edison seeks to have the complaint dismissed in its entirety, with prejudice.

C. Staff

Staff presented its own report on the allegations, Exhibit S-1. Largely consistent with this report and the testimony of Staff expert witnesses Mr. Liu and Mr. Welke,¹² Staff's briefs describe and characterize several accounting changes made by the company, but do not find that Detroit Edison violated the tracker conditions in the U-15244 order, or that the changes had any adverse impact on ratepayers. Instead, Staff is concerned with two aspects of the company's accounting: the decrease in the proportion of line clearance expenses capitalized and the direct-charging of restoration expenses to capital. Staff recommends that the line clearance accounting issues be addressed in Case No. U-16246, and that the Commission direct remedial action by Detroit Edison to improve its accounting procedures and internal controls to prevent the potential for error in its capitalization of restoration expenses.

D. Attorney General

The Attorney General did not file testimony or an initial brief, but in his reply brief agrees with Ms. Bates in part, contending that the company did change its accounting methods without Commission approval, and recommends that the Commission address those changes in Case No. U-16246, and further endorses Staff's recommendation for remedial action regarding Detroit Edison's capitalization of restoration expenses. The Attorney General further endorses Ms. Bates's claims regarding the treatment of revenues and expenses associated with jointly used utility poles, although he makes no

¹² Mr. Liu's testimony is at Tr 72-75; Mr. Welke's testimony is at Tr 67-71.

recommendation for further Commission action. To the Attorney General, Detroit Edison's intent is not relevant; rather, the key question is whether the utility made changes that increased restoration and/or line clearance expenses reported for purposes of calculating net income when compared with the results that would have been reported if Detroit Edison had made no changes.¹³

In the discussion that follows, the issues relating to the utility's accounting for costs covered by the restoration and line clearance trackers established in Case No. U-15244 are discussed in section III, while the accounting relating to Other Income and Deductions and joint use expenses are discussed in section IV.

III.

ACCOUNTING CHANGES RELATED TO TRACKING MECHANISMS

In its December 23, 2008 decision in Case No. U-15244, the Commission approved two tracking mechanisms or "trackers" in setting Detroit Edison's rates. The "restoration tracker" was adopted as a "two-way" tracker for all storm and non-storm restoration expense. The "line clearance" tracker was adopted as a "one-way" tracker. As noted above, Ms. Bates alleged in her complaint and in her testimony that the company made several changes to its accounting that were inconsistent with this order, or intended to increase amounts recovered under the tracker mechanisms.

A. Description of changes

In her brief, Ms. Bates identifies the following changes:

¹³ See Attorney General Reply Brief, pages 1-2, and 5.

- 1) The company started charging certain expenses previously classified as restoration to line clearance – specifically, the expense of sending a line clearance crew to clear vegetation during restoration work.
- (2) The Company started doing a “trouble capital journal entry” at the end of each month to move a portion of its restoration expenses from operations and maintenance to capital, which represented a double-capitalization of these expenses.
- (3) The Company changed the classification of three types of general corporate overhead expenses to front-line expenses so they would be eligible for the trackers.
- (4) The Company started making a standard journal entry that recued the capitalized portion of its line clearance expenses and increased the O&M portion of its line clearance, which increased its spending on the line clearance tracker.¹⁴

Each of these accounting changes is discussed in turn below, followed by a discussion of whether prior approval of the changes was required by the Commission’s order in Case No. U-15244, and whether any other concerns are raised by the changes.

1. Reclassification of Vegetation Removal During Restoration Event

The parties agree that in 2006, the base year used in setting the trackers, “line clearance” expenses primarily reflected expenses associated with the company’s planned vegetation clearance program. The company also incurs expenses to clear vegetation in storm and non-storm (trouble) restoration work, when line clearing crews are needed so that repairs can be performed. In 2006, these expenses were considered part of the company’s restoration costs. As such, they would have been eligible for inclusion in the restoration tracker, and were included in the data used to set the amount of that tracker. But in 2009, the company designated these expenses as “line clearance” expenses subject to the line clearance tracker.

¹⁴ See Bates Initial Brief, page 2.

Ms. Bates testified to this. Detroit Edison's Final Investigation Report acknowledges this change, but emphasizes that no other storm or non-storm restoration costs were assigned to the line clearance tracker, although a confusing internal memo needed to be corrected to make this clear.¹⁵ The Final Investigation Report states:

AS notes that there is one type of item that historically has been charged to restoration (aka trouble) that is now charged to line clearance. This item relates to situations in which a crew working on a restoration project calls out a line clearance crew to remove vegetation which obstructs the ability to restore power. Historically this type of line clearance would have been charged to restoration cost, and not line clearance. The amount of this type of expense is budgeted at approximately \$3 million for 2009.

Given that this item relates to both line clearance and restoration, this item could be accounted for either as line clearance or restoration, either of which would be appropriate. AS believes that changing which category this is charged to could be a change in accounting method, but notes that the Company is not due to file its reconciliation case that would be affected by this determination until early 2010. Moreover, AS does not believe that there are any circumstances in which there is a benefit to the Company of this change, and in fact circumstances in which there would be a detriment.¹⁶

Ms. Frisicaro testified that the actual amount recorded for in these expenses in 2009 was only \$1 million.¹⁷

Staff also confirms the accounting change, but labels it a "change in classification" rather than a "change in accounting method" or a "change in estimate".¹⁸

¹⁵ See Exhibit C-1, page 12, indicating that a May 5, 2009 memo indicated that "preventive maintenance" costs were to be charged to the Restoration Tracker, but Detroit Edison's subsequent report indicated that provision of the memo was erroneous. See also Exhibit C-2 (the May 5, 2009 memo) and Exhibit C-3 (a corrected memo dated October 15, 2009).

¹⁶ Exhibit C-1, pages 12-13.

¹⁷ See Tr 115.

¹⁸ See Exhibit S-1, page 3; Staff reply brief, page 2.

2. Double-Capitalization of Certain Restoration Costs

The parties generally agree that at least beginning with the introduction of the company's new software system (SAP), line crew performing restoration work would report their work, and the allocation of the labor and materials costs between capital and O&M was performed by Distribution Operations (DO) accounting personnel, who capitalized materials costs based on the capital nature of the materials and used standardized labor rates to determine the corresponding labor allocation for those materials. At some time, at least by June 2008, line crew were instructed to directly allocate or "direct charge" materials and labor costs to O&M expenses and/or capital accounts. Ms. Bates contended that during this time period, the same dollars were also being allocated (or reallocated) to capital through the continuing use of journal entries at the Distribution Operations level, resulting in a double-capitalization of the same restoration costs.¹⁹ Here is how the Detroit Edison Final Investigation Report describes the change:

Historically, costs associated with Storm and Non-Storm (Trouble) Restoration efforts were capitalized based on standard rates. As work was being performed, labor and materials were charged to O&M expense. At the end of the month, a Trouble Capital Journal Entry would be calculated and posted by DO personnel. Items requiring capitalization would be identified by materials with a capital profile. The entry would reclassify labor dollars based on average labor rates, applied to standard minutes per task. Materials were capitalized based on actual.

In mid 2008, management determined that the standards historically utilized by DO were outdated, as they had not been revised in a number of years. Moreover, these standards appear to have been based upon normal working conditions, rather than the more difficult situation usually involved in a storm or even a trouble event, in which weather and damage may cause significant additional time. DO Controllers began reviewing the capitalization methodology for Storm and Trouble costs, and

¹⁹ See Tr 33-34.

concluded that a direct charging structure would reasonably state capital costs associated with Storm and Trouble efforts. This new process requires filed employees to directly charge an O&M or Capital work order, depended upon the tasks being performed.

Management concluded on the direct charge process in May 2008, and it was implemented in June 2008, well in advance of the creation of the Restoration Tracker in December 2008. This change had the effect of decreasing the proportion of expenditures related to storm and trouble that is expensed and therefore counted under the storm and non-storm restoration tracker.

AS notes that during the transition from indirect capitalization based on standards to direct capitalization, there was a period of time where both were occurring (from approximately June 2008 through February 2009).²⁰

While Detroit Edison asserts that the journal entries were only used for crews that were not yet direct-charging capital and O&M, the audit report and witnesses testifying for the company acknowledged that the existing records did not enable the company to determine that this was so:

AS' procedures have indicated that there is, in fact, a potential that labor dollars were double-recorded as capital during this time frame. This would have been the instance where the individual charged his/her labor directly to capital, but the materials to O&M (while the materials related to this type of work are capital in nature, employees may have been charging O&M originally as per the old process and reclassified to capital through the month-end journal entry). As part of the month Trouble Capital ("indirect") reclassification, a labor standard would have been applied to these materials during the reclassification from O&M to capital, even though the labor had already been recorded to capital.²¹

Instead, the audit team performed an analysis, designed to show the possible extent of any double-capitalization. The analysis concluded that any double-capitalization would not have exceeded \$3 million, and this would have occurred between June 2008 and December 2008:

²⁰ Exhibit C-1, pages 18-19.

²¹ *Id.*, page 19.

In order to determine the maximum potential exposure of any double-labor capitalization, AS first summarized the labor portion of the indirect entry by month, and by DO business unit. AS noted that approximately \$17M of labor dollars were reclassified from O&M to capital through this indirect entry for the period June-December 2008. Note that AS' analysis excluded a review of January and February 2009, as approximately \$200k of labor was reclassified, which was deemed to be immaterial for further review.

From this \$17M, and based on the premise that no indirect entry should have been necessary where direct charges were occurring, AS then worked to identify where there was an overlap (by month and DO business unit) or both an indirect entry and direct charges occurring.

In order to identify the population of direct labor charges, AS ran a query from SAP of all internal orders that field crews were instructed to charge for direct labor charges of the nature with a potential double capitalization. This query resulted in minutes charged, by month, by business unit; AS extended the minutes by the labor standard rate utilized for the indirect entry.

AS then compared the dollar amount of direct charges to the amount in the indirect entry in each month and business unit and where there was an overlap (i.e. both direct charge and indirect capitalization) summarized the greater of the two by business unit, by month. This analysis resulted in a maximum potential exposure of less than \$3M.²²

Staff's report generally accepts the company's analysis of the potential double-capitalization.²³

3. Corporate Overhead Expenses

The third accounting change identified in Ms. Bates's brief involves corporate overhead expenses, which she alleged were inconsistently reported to the Commission.²⁴ The company acknowledged that in 2008, the company reclassified certain types of corporate overhead costs as "frontline trouble", making them eligible for the subsequently approved tracker mechanism:

²² *Id.*

²³ See Exhibit S-1 at page 8.

²⁴ See Bates Initial Brief at 18-19.

The company's discovery response in Exhibit C-12 states:

In 2008 three types of costs were reclassified from Corporate Overhead to Frontline Trouble having the effect of allowing these costs to be included in the tracking mechanism. These costs include: the Uncollectible portion of trouble related damage claims, a portion of the Regional Operation Center (ROC) and System Operations Center (SOC) expenses attributable to Trouble and a portion of dispatch related to Trouble. These reclassifications were made to be consistent with the 2006 base year classification as required by the Commission in its December 23, 2008 Order in Case No. U-15244.

Ms. Bates's brief quotes the first part of this response, and suggests that Detroit Edison should have sought approval for this change, but does not address the portion of the company's response claiming the change was made in order to keep the accounting consistent with the 2006 base year. No other party addresses this issue in their briefs, although Staff's initial brief references the discovery response at pages 4-5.

4. Change in Capitalization of Line Clearance Costs

The fourth accounting change identified in Ms. Bates's brief relates only to the line clearance tracker. When Detroit Edison crews perform planned line clearing activities, a portion of the expense should be capitalized. This is because the line clearance supports "pole top maintenance", which is "system strengthening" and considered a capital expenditure.²⁵ Line clearance expenses are thus allocated between O&M and capital accounts. Ms. Bates testified that historically the company had been capitalizing 10% of the line clearance costs, or approximately \$450,000 per month, but in 2009, the company changed to a fixed capitalization amount of \$150,000 per month.

²⁵ See, e.g., Exhibit DE-1.

The company's Final Investigation Report acknowledged the change, and claimed that a significant decrease in the company's planned expenditures for pole top maintenance was the impetus for the change:

Based on interviews conducted by AS and review of relevant supporting documentation, AS notes that a study was conducted in 2006 to provide a methodology for the capitalization of line clearance in support of pole top maintenance (PTM). Note that PTM is capitalized, as the work is considered to be circuit betterment or system strengthening. The purpose of the 2006 study was to determine the percent of line clearance that is performed in support of PTM, which is therefore also capitalizable. The 2006 study concluded that 10% of the line clearance O&M budget (for planned cycle work) should be capitalized in support of PTM. The underlying premise of the 2006 study is that the miles of line clearance and miles of PTM completed annually are similar. This was the case in 2006; therefore, the application of the 10% capitalization factor was appropriate.

In recent years, however, there has been a differential in the number of miles completed between the two programs. Largely as a result of capital constraints placed on the organization due to the current economic climate, PTM efforts performed by DTE Energy are projected to significantly decrease in 2009. In contrast, the Company is projecting to clear relatively constant miles in 2009. As a result, the growing differential between the two programs made an adjustment necessary to allocate the appropriate amount of line clearance to capital.

In Q1 2009, in conjunction with finalizing the capital budget estimates for 2009, DO management revised the amount to capitalize in order to determine whether previous estimates were still appropriate. As a result, management updated its estimate of line clearance to be capitalized and in March 2009 began recording \$150,000 per month. This change represents an update based on current facts.²⁶

Staff's report also recognized that the company increased its line clearance expense by changing the portion capitalized. Staff based its determinations on the admissions in the company's Final Investigation Report.²⁷

²⁶ See Exhibit C-1, pages 16-17.

²⁷ See Exhibit S-1, page 6.

Ms. Bates contends that the change in line clearance capitalization was made without a proper accounting basis in place to “spend up” to the line clearance tracker amount. Ms. Bates further argues that Commission approval of the accounting change was required by the Commission’s order in Case No. U-15244, and Detroit Edison failed to seek such approval.

Detroit Edison claims that the change in line clearance capitalization followed a Distribution Operations management “update” of its estimate of line clearance costs to be capitalized, but Detroit Edison did not document this update at the time the change was made. The Final Investigation Report further provides as follows:

AS notes that a formal study was not conducted in March 2009, and assumptions were not documented to support the amount of the estimate at the time it started being recorded. As such, AS was not able to validate the accuracy of the estimate of \$150,000 per month, although we do not believe that it is materially misstated. AS understands that conceptually the change from a percentage of expense to a flat rate was in order to make the entry administratively less burdensome.

At AS’s request, DO management is revisiting the \$150,000 and is developing formal documentation which will support their final estimate. Also at AS’s request, Accounting Research reviewed the change, and concluded that it represented a change in estimate in accordance with GAAP (via White Paper File Number 09Q3-300-17, dated August 18, 2009, “Line Clearance Capitalization”).²⁸

Staff’s report indicates as follows:

Staff was unable to determine whether the change in capitalization was done with the intent of ‘spending up’ the line clearance tracker amount. However, the Company could not provide documentation of the assumptions used or verify the accuracy of the updated capitalization method until seven months after the implementation of the updated capitalization method.²⁹

²⁸ See Exhibit C-1, page 17.

²⁹ See Exhibit S-1, page 6.

Staff suggests that if the Commission determines the change in capitalization was inappropriate, Staff could make recommendations in Case No. U-16246, addressing the line clearance tracker. These issues are discussed in the subsections that follow.

B. Review of Commission's Decision in Case No. U-15244

Ms. Bates contends that each of the changes described above violated the Commission's order in Case No. U-15244 requiring Detroit Edison to seek prior approval of accounting modifications. Detroit Edison denies any violation. The disputes turn in large part on the proper interpretation of the Commission's order. This order provided in part as follows:

The Commission adopts a two-way tracker mechanism for the storm and non-storm restoration expenses. The Commission agrees with Detroit Edison that the tracker mechanism should be adopted in a manner similar to the PEM. However, the Commission finds that the tracker mechanism shall be subject to review for reasonableness and prudence. If Detroit Edison incurs costs due [to] its own culpability or for a failure to reasonably maintain its facilities and lines, Detroit Edison may be prohibited from recovering resulting costs from ratepayers. In addition, **Detroit Edison shall not change its accounting method with regard to storm and non-storm restoration expenses without application to and approval by the Commission.**

* * *

Finally, the Commission agrees with the Staff that a one-way tracker for line clearance should be adopted. The Commission finds that such a tracker will help reduce restoration expenses. . . .

The Commission adopts a one-way tracker for line clearance that will be structured in a manner similar to Consumers Energy Company's forestry expense tracker in Case No. U-14347, with all applicable reporting requirements.³⁰

Detroit Edison argues first that it did not change its "accounting method", but only made revisions in accounting estimates in accordance with GAAP. Detroit Edison also

³⁰ See Case No. U-15244 (December 23, 2008 order), pages 54-55 (emphasis added).

argues that Commission approval of changes in accounting method is only required for the two-way restoration tracker, and not for the one-way line tracker. Additionally, Detroit Edison contends that approval was not required because none of the changes were material.

Interpretation of the Commission's order requires an analysis of the phrase "change in accounting method", a determination whether the requirement applied only to the restoration tracker or to both trackers, and a consideration of the extent of any materiality requirement implicit in the order.

1. Accounting Method

To Detroit Edison, its "accounting method" is "its overall policy based on GAAP, the MPSC Uniform System of Accounts, and accounting rules issued by the commission through its rate orders." It insists that it has not changed its "accounting method" using this definition. Once its "method" is established, Detroit Edison argues, a separate process is used to estimate and measure the value of related transactions, and thus any of the changes in its accounting should be considered changes in "estimate" rather than changes in "method". Detroit Edison cites SFAS 154, Accounting Changes and Error Corrections, a summary portion of which is set forth in Exhibit C-14. In particular, Detroit Edison relies on the following language:

A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information.³¹

³¹ See Exhibit C-1, pages 9-10; Exhibit C-14.

To Ms. Bates, SFAS 154 is inapplicable, because it is designed for future benefits and obligations, rather than O&M expenses, and the limitation on changes in accounting method set forth in the Commission's order should be interpreted to include a change in the accounting treatment of any material item. Ms. Bates uses IRS publications to show alternative uses of the phrase "accounting method."³² In particular, she points to the following language from Treasury Regulation 1.446-1 in Exhibit C-15: "The term 'method of accounting' includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item."³³

The Attorney General agrees with Ms. Bates, and argues that changes in "estimate" or "classification" that have the effect of increasing costs assigned to a tracking mechanism are changes in method.³⁴ The Attorney General urges the Commission to clarify this in its order in this case. The Attorney General cites an April 1998 Journal of Accountancy defining a change in accounting method as a "change in its overall plan of accounting . . . or a change in the treatment of a material item." To the Attorney General, the Commission's purpose in requiring approval of changes in accounting method was to ensure consistent treatment, and thus inconsistent treatments including changes in the classification of an expense item should be considered changes in accounting method.

Detroit Edison counters that any reliance on the IRS regulations would be "contrary to established regulatory practice and Michigan case law."³⁵ Detroit Edison

³² See Exhibits C-15 and C-16.

³³ See Tr 58.

³⁴ See Attorney General Reply Brief, pages 1-5.

³⁵ See Detroit Edison Initial Brief, page 8 and n11, citing *Colony Town Club v Michigan Unemployment Compensation Comm*, 301 Mich 107, 115; 3 NW2d 28 (1942).

also argues that the Commission cannot look to the IRS' use of "accounting method" to interpret the term because that would be "inconsistent" with SFAS 154.

This PFD concludes that SFAS 154 does not provide reliable or meaningful guidance in interpreting the Commission's order in Case No. U-15244. First, its purpose seems to be distinguishable. According to the descriptive material provided in Exhibit C-14, SFAS 154 sets forth the requirements for accounting for and reporting changes in "accounting principles" that affect a company's financial statements.³⁶ Second, SFAS 154 does not articulate separate and clear definitions of the terms "accounting method" and "accounting estimate." For example, it states the following in discussing depreciation methods for long-lived non-financial assets: "This Statement also requires that a change in depreciation, amortization or depletion method for long-lived non-financial assets be accounted for as a change in accounting estimate affected by a change in accounting principle." That is, a change in a "method" can also be a change in "estimate".³⁷ For these reasons, SFAS 154 is not a reasonable source from which to determine the meaning of the phrase "accounting method".

The American Heritage Dictionary (1981 Edition) defines "method" as follows:

1. A means or manner of procedure; especially, a regular and systematic way of accomplishing anything.
2. Orderly and systematic arrangement; orderliness; regularity. . .
3. The procedures and techniques characteristic of a particular discipline or field of knowledge.

A review of Commission decisions shows that the Commission has used the phrase "accounting method" broadly to refer to the accounting treatment of individual rate case

³⁶ And see Exhibit C-20, Attachment 2, focusing on "accounting principle" and "accounting estimate" as key terms in SFAS 154.

³⁷ See Exhibit C-14.

elements.³⁸ Detroit Edison has also described a change in cost allocation as a change in “accounting methodology”, as shown in Exhibit C-20, Attachment 3, discussing the change in allocation of Construction Work in Progress (CWIP) costs to Other Income and Deductions (OID) from a percentage of cost overruns to a fixed monthly amount.³⁹

Had the Commission meant only to refer to Detroit Edison’s overall plan of accounting, including compliance with GAAP, the Uniform System of Accounts and specific accounting orders issued by the Commission, there would have been no need for the condition. In establishing an open-ended tracking mechanism for restoration costs, the Commission was clearly concerned to be able to monitor the assigned expenses. Thus, reviewing the Commission’s order in its entirety, this PFD concludes that the Commission was concerned with any change in the accounting procedures or rules Detroit Edison uses to assign costs to the expense tracker.

2. Trackers Covered

Detroit Edison contends the prohibition on changes in its accounting method without Commission approval applies only to the restoration tracker. Ms. Bates argues that the requirement to obtain Commission approval of changes in accounting method applies to both trackers, the restoration and the line clearance tracker. She cites Staff’s report, indicating that while the prohibition “was specific to the two-way tracker, it was framed within a section of the Order addressing both the one and two way tracking mechanisms.”⁴⁰ Ms. Bates further argues that it is counterintuitive to interpret the order

³⁸ See, e.g. Case Nos. U-7395 and U-7397 (April 9, 1985 order) (recording election-related expenses below the line); Case No. U-11916 (May 3, 2000 order) (affiliate transactions); Case No. U-15467 (February 3, 2009 order) (capitalization of meter installation costs).

³⁹ See, e.g., Exhibit C-20, page 21) (“DECO should adjust its accounting methodology . . .”)

⁴⁰ See Staff report, Exhibit S-1, page 2.

to affirmatively authorize accounting changes that have the effect of increasing expenses paid by the ratepayers without Commission approval.⁴¹

While Ms. Bates and Staff are correct that the trackers were adopted together and are in some sense linked, because the commission expressly imposed the prior approval condition on the restoration tracker and expressly imposed other conditions on the line clearance tracker, this PFD concludes that the Commission did not intend to require prior approval of changes in accounting method for the line clearance tracker. Note that because it is a two-way tracker, the company's cost recovery under the restoration tracker is limited only by reasonableness and prudence, perhaps signaling to the Commission a need for greater control associated with advance approval of changes in accounting method. As the record shows, not all changes in accounting method can readily be undone.⁴²

Of course, consistent with this interpretation, the Commission retains authority to review and reject costs assigned to the line clearance tracker as a result of a change in accounting method.

3. Materiality

Detroit Edison also contends that none of the changes at issue are material, and therefore should not be considered a violation of the order in Case No. U-15244.

This PFD recognizes that while the Commission did not expressly include a materiality standard as part of its condition, the Commission did not intend to be badgered with trivialities. Nonetheless, a standard of materiality that focuses only on

⁴¹ See Bates Initial Brief at 23.

⁴² See Section A.2 above.

changes that have a material impact on the Company's financial statements seems significantly too high. As explained above, the Commission was concerned with the implementation of the uncapped restoration tracker. Materiality should be evaluated in this context. Any change in the treatment of costs assigned to the restoration tracker that could affect the comparability of reported results to the 2006 base used in setting the tracker, or affect Staff's ability to audit the costs the company assigned to the tracker, should have been the subject of a request for Commission approval.

Note that the Commission does not have a bright-line threshold for the materiality of adjustments in rate cases. Even in a rate case for a large company such as Detroit Edison or Consumers Energy, the Commission frequently focuses on items that taken alone would not have a significant impact on the company's revenue requirement.⁴³ In setting rates, the Commission is concerned with accuracy. Numerous small adjustments also can have a much more significant impact when cumulated. Thus, a change of \$1 million is not "immaterial" in the context of a rate case and it is not immaterial in the context of reviewing expenses assigned to restoration tracker, which would be expected to include total expenses on the order of the \$110 million amount the Commission included for those items in its rate case order.

4. Application

Based on the foregoing review of the Commission's decision in Case No.

⁴³ See, e.g., Case No. U-16191 (November 4, 2010 order, page 40)(\$400,000 corporate services adjustment); Case No. U15768 (January 11, 2010 order, page 49)(\$328,000 board of directors' expense); Case No. U-15244 (December 23, 2008, page 63) (\$949,000 Green Current program expense); Case No. U-14347 (December 22, 2005)(\$70,000 government and public affairs expense).

U-15244, this PFD concludes that Detroit Edison violated the Commission's order by failing to seek Commission approval for the reclassification from the restoration tracker to the line clearance tracker of expenses associated with clearing vegetation during restoration work. This was a change in accounting method for which Commission approval was required. When the company made this change, the vegetation removal expenses at issue were estimated to be \$3 million; the actual expenses for 2009 were \$1 million. Again based on the foregoing discussion, a reclassification of \$1 million is material to the Commission's review of the company's tracker expenses.

To Detroit Edison, there is no basis for Commission concern because there is nothing unreasonable or misleading about the change, and there are no circumstances in which it would benefit from the change.⁴⁴ Detroit Edison should have left any decision about the consequences of this change in accounting method to the Commission by following its order and seeking approval of the accounting change.

Considering the company's argument that it did not benefit from the change, however, it instead appears that Detroit Edison could have perceived some benefit from increasing its apparent expenditure on line clearance activities. While both categories of expenses were covered by a tracker, the record shows the company was concerned that its line clearance spending would be less than the Commission-approved amount.⁴⁵ In Case No. U-15244, Detroit Edison requested a tracker for the restoration expenses due to their volatile nature:

Accordingly, Detroit Edison proposed that the Commission normalize restoration expense over a five-year period from 2002 through 2006. This

⁴⁴ See Detroit Edison Initial Brief, page10; Tr 87, 115-117, Exhibit C-1, pages 12-13.

⁴⁵ See Bates, Tr 59.

would result in a \$25 million increase from the historical 2006 expense. In the alternative, Detroit Edison requests that the Commission adopt a true-up mechanism similar to the PEM. If the restoration expense is higher or lower than that reflected in rates, Detroit Edison would either charge or refund ratepayers through a temporary surcharge or credit. Detroit Edison argues that such a true-up mechanism would be appropriate since the Commission has implemented similar mechanisms in other recent cases to establish and reconcile volatile expenses in the ratemaking process.⁴⁶

In granting the request, the Commission also adopted the line clearance tracker based on Staff's recommendation, which focused on the link between preventive maintenance and restoration expenditures:

The Staff stated that if the Commission decides to implement a true-up mechanism it should be done in a way that mitigates restoration expenses. If the Commission adopts Detroit Edison's proposal, i.e., a two-way tracker, the Staff recommends that the Commission also adopt a one-way tracker for line clearance expense. According to the Staff, there is a correlation between line clearance and storm and non-storm costs. This would require Detroit Edison to mitigate the frequency and duration of outages if restoration expenses are recoverable from ratepayers. The Staff proposes that the one-way tracker function similarly to the Consumers Energy Company's forestry expense tracker in Case No. U-14347, with all applicable reporting requirements.⁴⁷

Recognizing that the Commission would likely evaluate the company's line clearance activities in conducting a review of the reasonableness and prudence of its restoration expenses, the company could reasonable have perceived a benefit in enhancing its apparent effort at preventing or mitigating restoration costs.

Turning next to the third and fourth accounting changes described above, this PFD concludes that the Commission's order in Case No. U-15244 did not require the company to seek advance Commission approval of these changes.

⁴⁶ December 23, 2008 Order at page 50.

⁴⁷ December 23, 2008 Order, page 52

With respect to the company's change in the assignment of corporate overhead costs, discussed in subsection A.3 above, the changes made by the company in 2008 were intended to conform to the accounting method used in 2006, the base for the tracker. Since the company was undoing a change that would have made reported results not comparable to the 2006 base, there was in essence no change to seek approval of.

With respect to the change in line clearance capitalization from a percentage to a lower fixed-dollar amount, described in subsection A.4, while this should be considered a material change in accounting method, it should not be considered a violation of the prior approval provision of the Commission's order because it involves only the line clearance tracker.

Turning to the change in the company's method of capitalizing restoration costs, discussed in subsection A.2 above, Detroit Edison argues that this cannot be considered a violation of the Commission's order in Case No. U-15244 because the decision was made in 2008, before that order was issued. While the change in capitalization methodology is a change in accounting method, and is a material change, it did occur before the Commission's December 23, 2008 order. Although Detroit Edison should have informed the Commission of this change following implementation of the tracker,⁴⁸ the company's omission did not technically violate the express prohibition on changes in accounting method without prior approval.

⁴⁸ See, e.g. Uniform System of Accounts, R 460.9001: "5. To maintain uniformity of accounting, utilities shall submit questions of doubtful interpretation to the Commission for consideration and decision."

C. Other Concerns

Although this PFD finds that Detroit Edison did not violate the Commission's order in Case No. U-15244 by changing its capitalization methodology for both restoration and line clearance expenses, these changes raise other concerns.

The company's change in the method used to capitalize a portion of restoration costs may have resulted in double-capitalization of over \$2 million in expenses. Detroit Edison argues that this amount is not material, even in a rate case, and that ratepayers were not harmed because the double-capitalization would have moved dollars away from the tracker. Consistent with the discussion in subsection B.3 above, this PFD finds that a \$2 million double-counting error would be considered material in a rate case. Moreover, if the double-capitalization occurred, it occurred in 2008, when there was no tracker in place. As Ms. Bates testified, in 2008, this would have had the effect of increasing Detroit Edison's stated income and assigning a portion of costs that should have been covered by 2008 revenues to ratebase, likely to be recovered from future ratepayers.

But it is the company's inability to fully audit the capital assignments to determine if double-capitalization had in fact taken place that presents the greatest cause for concern. While Staff did not perceive any harm from the company's accounting change, Staff's report nonetheless recommends remedial action:

Still, the company should improve its accounting procedures and its internal control to reduce the potentiality of such errors. For this purpose, Staff recommends the Company change the accounting procedures, document the changes and provide an explanation of what the changes are designed to prevent to the Commission. Staff recommends that the Company provide a report to the Commission filed to this docket within 90

days after the implementation of the changed accounting procedures and the internal controls.⁴⁹

Staff's recommendation is reasonable and should be adopted.

The company's change in the capitalization of line clearance expenses from a percentage to a much smaller fixed amount also raises a concern. As explained in subsection A.4 above, the company made this change in 2009 without any supporting documentation.⁵⁰ The change increased the amount of costs assigned to the line clearance tracker and significantly reduced the amount capitalized for pole top maintenance. The Final Investigation Report noted the absence of supporting documentation. Ms. Bates and Staff noted the length of time it took the company to create documentation to support its estimate.

Exhibit D-1 is an August 18, 2009 memo addressing line clearance capitalization. As explained above, and as indicated in this memo, an "updated study" was still in progress at this point. Staff's report indicates that the company provided this updated study in a January 12, 2010 memo, 10 months after the March 2009 change in the capitalization method, although that memo was not provided for this record.

The company's after-the-fact explanation for the change is that it decided to reduce pole top maintenance work from the \$65.5 million budgeted for 2008 to \$12.5 million for 2009, a reduction of 80%, following the Commission's decision in Case No. U-15244.⁵¹ This explanation is difficult to reconcile with the conditions the Commission imposed on the restoration tracker. As explained above, the Commission conditioned

⁴⁹ Exhibit S-1, page 9.

⁵⁰ See Exhibit C-1, page 17; Exhibit S-1, page 6.

⁵¹ See Exhibit DE-1. Neither Ms. Uzenski nor Ms. Frisicaró indicated any involvement with the decision at the time it was made, and their testimony was based only on what they had later been told by others.

recovery of restoration tracker funds on reasonable and prudent expenditures, including preventive maintenance to mitigate restoration expense. While the Commission established a line clearance tracker, pole top maintenance is also an activity to mitigate restoration expense.

In contrast, Ms. Bates testified that just prior to the Commission's Case No. U-15244 order, the company renegotiated contracts with its line clearance companies, saving \$2 million. She further testified that once the tracker was implemented, she attended meetings to discuss how to maintain the line clearance spending level despite the expense reductions.⁵²

Based on this record, the company's change in line clearance capitalization appears arbitrary and inconsistent with reasonable accounting procedures. While no party proposed remedial measures, Staff indicated that if the Commission determined the change was improper, it would have an impact on the line clearance expense. Because the record in this case does not permit a review of the company's currently stated basis for its line clearance capitalization, this PFD recommends that Detroit Edison be directed to file for Commission approval of its method for determining the amount of line clearance costs that should be capitalized. As part of its filing, the company should provide information on its pole top maintenance costs for 2008 and 2009, and expected costs for 2010 through 2012, so the Commission can determine whether regular adjustments should be permitted. In addition, this PFD recommends that the Commission require Detroit Edison to seek prior approval of any changes in accounting method for its line clearance tracker.

⁵² See Tr 59.

IV.

OTHER INCOME AND DEDUCTIONS

Two other accounting issues raised by Ms. Bates relate to the assignment of certain Distribution Operations expenses to Other Income and Deductions (OID).⁵³ Distribution Operations is responsible for utility poles shared with other users (joint users) such as other utilities or telecommunications companies. In addition to maintaining these poles, Distribution Operation undertakes capital projects for Detroit Edison that may incidentally involve work for joint users, such as moving lines or wires. The work done by Detroit Edison relating to the jointly-used poles, and the revenue it receives from the joint users for performing this work, are also referred to as Work as a Contractor (WAAC) expenses and revenues. Detroit Edison generally considers WAAC expenses and revenues non-regulatory, or “below the line”, so they are booked to OID.

Section A below addresses Ms. Bates’s claim that in accounting for the incidental WAAC costs incurred when it undertakes capital projects, Detroit Edison double-booked expenses to OID. Section B below addresses her claim that in accounting for all its WAAC expenses and revenues, Detroit Edison has actually booked only the revenues to OID, but not the expenses.

A. Double-Booking Expenses to OID

When Distribution Operations undertakes capital projects with incidental work for the third-party joint users as described above, it attempts to estimate these WAAC costs and assign them to OID. It also attempts to distinguish project costs that should be capitalized from other costs that should be expensed, including removal costs and

⁵³ While the parties discuss these as two separate issues, they appear to be related, as discussed below.

maintenance costs. Removal costs are assigned to accumulated depreciation and amortization; maintenance costs are assigned to O&M.

Ms. Bates alleged in her complaint that Detroit Edison double-booked expenses of approximately \$15.4 million to OID in allocating the costs of these capital projects.

During my work on the Lines Work in Progress project, I discovered that Distribution Operations Controllers had been accruing approximately \$7,700,000 in Other Income and Deductions (OID) expenses yearly, since approximately April 2007. The methodology changed in April 2007 when the Company implemented a new software system. This new method was intended to be temporary, but the Company has continued to use this method through March of 2009. This accrual moves expenses/dollars from Capital to OID for items that are not part of completed Property Plant and Equipment.⁵⁴

Detroit Edison does not dispute that it double-booked expenses to OID, the company asserts that the magnitude of the error was greater than Ms. Bates initially thought, and it challenges her assertion that she brought this concern to the company's attention:

Ms. Bates is partially accurate in alleging that Edison had been overcharging OID expense, but she is inaccurate regarding (1) the timing of the error (alleging it dated back to April 2007, when it really started in early 2008); (2) the amount of the error (alleging amounts that were less than the amounts that Edison correctively recorded following substantial efforts after her termination); and (3) her alleged discovery of the error (DO Controllers working with Asset Management identified a potential issue, and she was assigned to research it).⁵⁵

To understand the error at issue, it is necessary to understand the two-stage accounting process Detroit Edison uses to make the assignment of the estimated non-capital costs of these projects. Initially, the field workers charge their time to Construction Work in Progress (CWIP), rather than breaking their time down by

⁵⁴ See Tr 41-42.

⁵⁵ Detroit Edison Initial Brief, pages 16-17, citing Tr 126-127; Exhibit DE-3, pp 19-22

function. Prior to its SAP implementation, the company (through the DO controllers) made entries each month to reclassify the non-capital portion of the expenses, temporarily, to line removal, O&M, and OID. This monthly entry was referred to as the Lines Work in Progress (LWIP) entry. And also prior to SAP, the temporary reclassifications were finalized and made permanent when the CWIP was “unitized”, i.e. when the capital items were moved to a plant account on completion of the project and depreciation commenced.

The SAP system implemented in April 2007 was apparently supposed to handle both the initial LWIP allocation and the unitizations. Ms. Bates seems to indicate that the double-expensing error began at this point, because the SAP system was duplicating the initial LWIP OID expense assignment. The company’s Final Investigation Report blames the manual “unitization” process implemented shortly thereafter because the SAP was not performing the unitizations.⁵⁶

Sorting through the non-chronological explanation in the Final Investigation Report, the following timeline emerges. In December 2006, the company revised its estimate of joint use costs initially booked to CWIP from a percentage basis to a fixed amount:

In December 2006, a study was conducted to determine the best estimation methodology for reclassifying joint use costs from CWIP to OID. Given the recurring nature of joint use operations, expenses were expected to be relatively constant from job to job for incidental joint use work. Therefore, the calculation for the joint use portion of LWIP was revised based on a Trouble Capitalization Analysis for Detroit Edison and Contractor Fully Loaded Blended Labor Rates, netting a standard labor rate per minute. This standard labor rate was multiplied by the average monthly minutes predicted to be spent on joint use projects resulting in a

⁵⁶ See Exhibit C-1 at pages 22-23.

static monthly expense of approximately \$600k that would be reclassified between CWIP and OID (approximately \$1.9M per quarter).⁵⁷

Subsequently, around the time of SAP implementation, the company conducted another study, looking at data from 2004 through February 2007 for DO capital projects, and determined revised percentages for both removal costs and O&M as a portion of CWIP.⁵⁸

Then, when SAP was implemented in April 2007, the initial adjustment of CWIP through the LWIP entry was supposed to change:

SAP was intended to automatically perform unitization and retirements, including LWIP reclassifications, based on settlement rules established within the system. The long-term goal with SAP was for unitization to occur real-time, therefore reducing or eliminating the LWIP entry altogether. In 2007, however, the system was not automatically unitizing costs out of CWIP, and in fact there was a period in which little CWIP was being unitized, resulting in a backlog.⁵⁹

Instead, the company explained, after SAP implementation the company continued to make manual LWIP reclassifications on a monthly basis as an interim step prior to unitization, but the entries were made in Asset Management, rather than by the DO Controllers.⁶⁰

With a backlog of CWIP developing over 2007, the company launched what it referred to as a “mass asset unitization improvement project” in February 2008, “to remediate the 2007 backlog and improve the unitization process.” The Final Investigation Report looks back to the December 2006 change to a fixed dollar amount

⁵⁷ See Exhibit C-1, page 23.

⁵⁸ Unlike the 2006 change in the estimation of OID costs, there is no memo memorializing this change.

⁵⁹ See Exhibit C-1, page 22.

⁶⁰ *Id.*

for the reclassification of CWIP to OID, while percentages were used to reclassify CWIP to removal cost and O&M, and concludes as follows:

Because of the use of a fixed dollar amount rather than a percentage of CWIP (used for other portions of the LWIP entry), this portion of the entry needed to be adjusted as soon as assets started to be unitized, as otherwise there would be a double booking of this expense, once as part of the unitization process, and also as part of the LWIP entry. The fact that the LWIP monthly estimate process should change when the unitization process was reinstated in February 2008 was overlooked, resulting in an error.⁶¹

The final report also suggests that the reason for the use of a fixed dollar amount to estimate OID expense initially was the lack of historical data.⁶² As a result of its investigation, the company contends it “validated” the appropriate use of percentages of CWIP for O&M and removal costs, but concluded that a percentage (rather than a fixed dollar amount) should now be used for joint use expense as well. The June 2009 adjustments made by the company in part reflect this change in estimate of OID expense from a fixed dollar amount of CWIP to a percentage of CWIP.

Exhibit C-20 contains two memos that shed additional light on this error. Attachment 3 is a December 13, 2006 memo memorializing the December 2006 study referenced above.⁶³ It is titled “Allocating Joint Use Costs for Work as a Contractor”. It provides the background for the use of a fixed-dollar allocation of CWIP to WAAC expense in OID. Apparently, for Distribution Operations, financial results showed “other deductions” exceeding “other income” by \$5 to \$21 million annually from 2001 to 2005. The memo indicates that one cause of this was the way that expenses were assigned to WAAC when capital projects were undertaken with incidental work on joint use poles.

⁶¹ See Exhibit C-1, page 23.

⁶² See Exhibit C-1, page 24.

⁶³ See Exhibit C-20, pages 16-22,

At that time, only costs that were considered to be in excess of the expected project costs were allocated to WAAC: using standardized cost estimates, for any given project the amount of “cost overrun” was computed, and half of any overrun assigned to WAAC in OID.

By switching to a fixed allocation per project, the company estimated it would reduce its WAAC expenses by as much as \$6 million annually, and correspondingly increase the amount of project costs capitalized by \$6 million.⁶⁴ The memo notes:

[G]iven its recurring nature, revenue and expenses are expected to be relatively constant from job-to-job for incidental joint use work. (Since this activity is considered non-regulatory in nature, costs are recovered from 3rd parties through monthly billings and not passed on to ratepayers through customer billings.) Furthermore, revenue from contract work is expected to approximate costs per [FERC] accounts 415 and 416, respectively. . .

The memo does indicate that the new fixed monthly allocation is supposed to separate the WAAC allocation from the unitization process. It also indicates that even prior to SAP implementation, there was a significant backlog of CWIP to be unitized.

Exhibit C-20, Attachment 1, is a June 19, 2009 memo addressing the adjustments to be made to CWIP and other accounts following discovery of the error. It is entitled “Joint Use Charges for Estimated Line Work in Progress.” This memo describes the error leading to the double-counting, and its correction, as follows:

Upon resumption of the unitization process for mass capital projects that contained joint use costs, the Company failed to reverse the portion of the estimate related to actual joint use expenses charged in the unitization process; therefore, the joint use costs were effectively expensed twice for

⁶⁴ “Prospectively, based on the use of the revised methodology, it is estimated that as much as six million (\$6M) per year related to new projects will remain as a plant asset rather than be allocated as joint use costs (non-regulatory).

completed projects. Because the \$1.8 million or \$1.9 million fixed rate allocation was the best estimate at the time, the error portion of the OID adjustment is isolated to the failure to reverse the actual expenses.⁶⁵

The Attachment 1 memo also provides additional information on the steps the company took once the double-counting error was discovered. In particular, it describes in more detail the 2009 revisions the company made in the estimation of O&M, joint use expense and removal cost associated with DO capital projects. The new percentage allocation factors are presented, although the prior percentages for O&M and removal costs are not shown.⁶⁶ In addition to correcting the double-expensing of the fixed joint-use allocation, the June 2009 adjustments made by the company implement the new allocation factors effective March 2009. The memo describes the resulting changes to the various entries:

Applying the revised factors to the March 2009 CWIP balance resulted in an adjustment to the LWIP of \$9.5 million, comprised of \$9.8 million of removal costs, \$15.2 million of other income related to joint use, which is included in [OID], and \$4.1 million of O&M expense.

The adjustment resulting from the change in the allocation percentages of O&M and joint use is a change in estimate of \$5.6 million and will be accounted for prospectively. The balance of the adjustment, resulting from the failure to reverse the portion of the estimate related to actual OID expenses recorded upon unitization, is considered a prior period error in the amount of \$3.9 million pre-tax.⁶⁷

Staff's report focuses on the company's 2009 correction to 2008 OID expenses, a prior period adjustment, made through a \$3.9 million correcting journal entry in June 2009. Staff's report further concludes that the effect on ratepayers is indeterminable

⁶⁵ See Exhibit C-20, page 6.

⁶⁶ See Exhibit C-20, page 5, showing 84.85% of the project costs allocated to Plant in Service, 13.3% to removal costs, .75% to OID, and 1.1% to O&M, with these percentages to change as additional data becomes available.

⁶⁷ See Exhibit C-20, page 4.

because rates established in Case No.U-15768 were based on projected test year data and did not entirely rely on historical data.⁶⁸

No party seems to dispute that the company has changed its process and is no longer double-booking OID expenses. No party proposed any further remedial action to address this error. And no party took issue with the revised expense allocations to OID, removal, or O&M.

Ms. Bates and Staff ask the Commission to make specific findings of fact. Ms. Bates asks the Commission to: “Declare that the Company double-booked OID expenses related to Lines Work in Progress during 2008.”⁶⁹ Staff asks the Commission to find:

The Company double-booked OID expenses during 2008, resulting in a \$3.9 million journal entry correcting that error in June of 2009. The effect on ratepayers is indeterminable because in MPSC Case No. U-15768 the rates were based upon projected test year data and did not entirely rely on historical data.

Detroit Edison does not challenge either of these statements, and both are correct.

Instead, as noted above, Detroit Edison challenges certain details of Ms. Bates’s testimony. Regarding the amount of the error correction, Detroit Edison faults Ms. Bates for identifying an error of \$15.4 million when its total 2009 adjustment was approximately \$20 million.⁷⁰ It also faults her for not indicating in her May 2009 white paper that the error affected prior period results in addition to 2009. While this appears

⁶⁸ See Staff initial brief at 11-12; Exhibit S-1, page 9, indicating the company attributed the \$3.9 million to “an error in measurement as a result of an oversight or misuse of facts.”

⁶⁹ See Ms. Bates Initial Brief, page 36.

⁷⁰ See Detroit Edison Initial Brief, pages 16-17.

to be a minor dispute, it is worth noting that the record does not establish that Ms. Bates's estimation of the double-counting error was wrong. The company concluded that it could adjust the allocation percentages for 2009, and need make a correction of only \$3.9 million for 2008, but it did not directly refute her claim that approximately \$1.9 million in expenses per quarter were double-booked to OID. That her May 2009 memo did not include prior period adjustments is explained by her initial testimony that she was instructed to address only 2009 by her supervisor. And that the magnitude of the ultimate adjustments was not the same as her memo proposed or her testimony referred to appears to be attributable at least in part to Detroit Edison's decision to change its estimation of the amount of each capital project to allocation to OID, removal costs and O&M.

Detroit Edison also disputes that Ms. Bates discovered the error. Again, the record evidence on this point is inconclusive. Ms. Frisicaro testified on this point, but she indicates only that Detroit Edison management had "become aware of a potential issue relative to the monthly LWIP entry", and that Ms. Bates's claim is disingenuous because she had been assigned to work on this issue, on or before January 2009. But Ms. Frisicaro does not affirmatively state that Detroit Edison had identified the double-booking of WAAC expenses; her testimony is equally consistent with the company determining to revisit the amounts of CWIP to allocate to OID, removal and O&M. Ms. Frisicaro's testimony references the Final Investigation Report. But like Ms. Frisicaro's testimony, the Final Investigation Report suggests but does not affirmatively state that Detroit Edison was aware of the double-counting. No documentary evidence was provided that would indicate Detroit Edison management understood the company had

double-booked the OID expenses for many quarters. After all, rather than simply reverse the double-booking, the company's 2009 adjustment made several other changes to its accounting. Figuring out the appropriate estimators to use for the expense categories could account for the additional effort Detroit Edison expended on this issue after Ms. Bates employment was terminated.

Finally, Detroit Edison faults Ms. Bates for indicating the error began in April of 2007 with the switch to SAP. While it appears from the company's report that the double-expensing did not begin until February 2008, the backlogged unitizations that were handled appear to involve CWIP bookings dating to April 2007. Ms. Uzenski also traced the source of the error to April 2007: "Upon implementation of SAF in April 2007, this transfer from capital to expense was not being recorded by the system so manual entries were processed to ensure capital and expense was properly stated. The manual transfers were based on estimates."⁷¹

B. Work as a Contractor Expenses Not Traceable to OID

As discussed above, the company performs WAAC for joint users of its poles, for which it receives revenue. Theoretically, and as explained in Exhibit C-20, Attachment 3, these costs and revenues are booked to OID because the activity is considered non-regulatory.⁷² Ms. Bates testified that while the WAAC revenues show up in the company's OID accounting, the corresponding expenses do not.⁷³ She initially presented Exhibits C-7 and C-8, which are company internal budget and financial statements. Exhibit C-8 shows "actual" WAAC revenue significantly exceeding "budget"

⁷¹ See Tr 93.

⁷² See also Uzenski, Tr 91; Bates Tr 60.

⁷³ See Tr 39-40, 51-52, 60-61.

revenue, and “budgeted” WAAC, but virtually no “actual” WAAC expenses. Her rebuttal Exhibit C-17 also contains joint use expense statements for September 2009 showing budgeted revenues of \$1.644 million but year-to-date expenses of only \$102,433. Ms. Bates testified that the difference between the year-to-date revenues and expenses reflect expenses that were booked to other cost centers, and she called attention to the note on page 4 of Exhibit C-17 stating “invoices coded to other cost centers.” Explaining why she presented the unaudited internal documents, Ms. Bates affirmed that the company does rely on budget documents, and further testified that the company has been omitting WAAC expenses from such reports since at least 2007. Exhibit C-19 contains joint use revenue and expense reports going back to December 2006, all showing WAAC revenues, but virtually no actual WAAC expenses.

Detroit Edison does not deny that WAAC expense is a “pass through” cost. Instead, Detroit Edison’s Final Investigation Report focuses on \$9.5 million in expenses paid to AT&T for Detroit Edison’s joint use of its poles that were booked as O&M, and indicates that this treatment was proper because Detroit Edison’s utility customers benefitted from the joint use of the AT&T poles. Additionally, the report acknowledges a lack of transparency in its OID accounting. The company’s Final Investigation Report also indicated: “there was a lack of internal reporting transparency into the items flowing through OID, specifically for joint use activity.” But, it said that joint use financial statements were created in early 2009 which more concisely present the information for management’s needs.⁷⁴

Ms. Frisicaro also testified regarding the audit team’s findings:

⁷⁴ See Exhibit C-1, page 15.

AS identified a set of joint use financial statements prepared by DO controllers used . . . solely for management analysis. AS noted one type of expense included in the Joint Use Revenue and Expense budget for 2009 O&M. AS noted, a 2009 budget of approximately \$9.5 million for pole rental expense being recorded through O&M. AS validated, through inquiry, that this classification is consistent with past years. AS also requested a review by Regulatory Accounting, to validate the appropriateness of charging this to O&M. Based on the nature of the expense, Regulatory Accounting concluded that classification through O&M is appropriate.⁷⁵

Ms. Uzenski testified to the Regulatory Accounting review:

Regulatory Accounting reviewed the classification of joint use transactions and concluded that the expenses were appropriately captured. In fact, most joint use revenue is recorded as a credit above the line (in operating revenues) reducing the revenue requirement for customers. Detroit Edison does provide a minor level of services to third parties, effectively working as a contractor. The costs incurred to provide those third party services are classified “below-the-line” in OID. . . , offset by the related third party revenue. Detroit Edison’s utility customers are not paying for expenses that it incurred to provide joint use services to its non-utility customers.⁷⁶

And on rebuttal she reiterated:

[T]he Company reviewed joint use transactions and concluded they were classified appropriately. Ms. Bates’ allegations are based on internal management reports that do not reflect the classification used for external SEC and MPSC reporting.⁷⁷

Staff found no conclusive evidence to confirm Ms. Bates’s allegation.⁷⁸ As explained in Staff’s report, Staff was unable to reach a conclusion on the joint use expenses because the documents supplied by Ms. Bates, Exhibits C-7 and C-8, reflect internal budget projections/reports made by the company, rather than audited financial

⁷⁵ Tr 121-122.

⁷⁶ Tr 91.

⁷⁷ Tr 97.

⁷⁸ See Welke, Tr 70.

reports: “Staff is unable to reach a conclusion because internal budget reports are not appropriate source documents from which Staff makes definitive conclusions.”⁷⁹

Staff also reviewed company responses to audit requests provided in Case No. U-15244, indicating a problem with the company’s accounting for WAAC, but also indicating that a report would be forthcoming:

According to these responses, when the conversion to SAP took place, communication did not effectively take place to inform all accounting personnel that manual steps would need to be taken to unitize and transfer charges out of Account 107-Construction Work in Process to OID through the unitization process. The Company addressed this issue by forming a Joint Use Team that met with asset Management and mapped out the process that needed to take place to unitize and recognize OID. **According to the Company, this unitization and recognition of OID is taking place and the Company is working on producing a report to evidence that WAAC [Work As A Contractor] revenues and expenses flow to OID.**⁸⁰

Staff and the company also contend that even if expenses associated with Work as a Contractor were booked to O&M in 2009, there would be no harm to ratepayers since 2009 has not been a test year for ratemaking purposes. Ms. Bates responded that the differential treatment of WAAC revenues and expenses has been ongoing since at least 2007.

In its reply brief, Detroit Edison asserts that AS and Regulatory Accounting determined that the expenses were appropriately recorded, and that most joint use revenue is recorded in operating revenues, above the line (rather than in OID), reducing the revenue requirement for ratepayers. It further states: “Edison provides a minor level of services to third parties, with the related costs classified in OID (below the line),

⁷⁹ See Exhibit S-1, page 4.

⁸⁰ See Exhibit S-1, page 4 (emphasis added).

offset by the related third-party revenue. Edison's utility customers are not paying for expenses that it incurred to provide joint use services to its non-utility customers."⁸¹

Detroit Edison does not directly address the discrepancy between WAAC revenues and expenses booked to OID as shown on Exhibits C-7, C-8, C-17 and C-19, although the explanation quoted above seems to acknowledge that the two should be roughly equivalent. Nor does Edison address the additional company analysis that Staff's report indicated would be forthcoming.

It is puzzling why the company's internal reports do not reflect WAAC expenses offsetting third party revenues. As discussed above in section A, beginning in 2007, the company estimated approximately \$1.8 million per quarter for such expenses. While it indicated that its internal statements are not based on the same classifications used for SEC and MPSC reports, it did not explain why it would omit these expenses from its internal reports. What management purpose could it serve? Note, too, that the discussion of WAAC in Exhibit C-20, Attachment 3 makes no mention of differing internal treatment of these expenses in indicating that they should be considered OID. The company's Final Investigation Report noted that joint use financial statements were created in early 2009 which more concisely presented information for management needs, but as Ms. Bates testified, the internal statements of joint use OID omit WAAC expenses going back to 2007. And while the final investigative report appears to verify the company's "classification" of expenses, it does not directly conclude that expenses were appropriately accounted for in accordance with the established classifications in reports made to the MPSC. Note that the Final Investigation Report, at page 16, states

⁸¹ See Detroit Edison reply brief, page 22, citing Tr 91 and 97.

only that: “AS found no evidence of joint use costs inappropriately recorded through O&M expense,” but did not indicate that it was able to verify that all WAAC costs were appropriately accounted for.

While Staff is clearly reasonable in refusing to rely on budget documents rather than audited financial statements, Staff also is expecting the company to provide information establishing how OID expenses have been accounted for. For these reasons, this PFD finds that it is more probable than not that the company did not book all WAAC expenses to OID in accordance with its established classifications. To ensure that it has appropriately accounted for these expenses in its reports to the MPSC, or to correct its reporting if there has been an error, the company should submit the report described by Staff in this docket, a report to evidence that WAAC revenues and expenses flow to OID, covering the time period 2006 to the present.

V.

MISCELLANEOUS MATTERS

Ms. Bates presented additional testimony indicating that her supervisor, Sakina Howard, had given her instructions to exclude information from her emails and to label her documents to prevent or limit disclosure of information to the Commission.⁸² The Final Investigation Report indicates that the audit team found no evidence of this. Ms. Uzenski, who did not directly supervise Ms. Bates, testified at Tr 89-90 suggesting Ms. Bates “misunderstood” the instructions she was given. Ms. Bates flatly contradicted that suggestion.

⁸² See Tr 38, 50-51.

Ms. Uzenski also testified to her belief that Ms. Bates may not understand the regulatory process. She explained that the thought processes behind management's decisions are generally not documented, as to avoid misinterpretation or misrepresentation by outside parties, and further, that part of the administrative process is to remind employees involved in Commission filings that documents they prepare may be discoverable.

Detroit Edison also argues in its briefs that since it had no reporting obligations with regard to the tracker during 2009, it could not have hidden anything.

On this record, Ms. Bates's testimony as to communications from her supervisor is uncontradicted by any person with first-hand knowledge. While Ms. Howard's name appears on discovery produced by Detroit Edison, she did not testify in this proceeding. Ms. Uzenski testified in part:

I personally, and Detroit Edison as a whole, take seriously our responsibilities to respond accurately and completely to information requests made by the Commission.⁸³

While Ms. Uzenski clearly testified to the official policy of Detroit Edison, the Commission should nonetheless be concerned that individuals at the company may be taking actions to thwart Staff access to information.⁸⁴ To address this concern, this PFD recommends that the Commission caution Detroit Edison that it is obligated to maintain its books and records according to established standards, and it is obligated to fully respond to Staff audit requests. As indicated in the Uniform System of Accounts, R 460.9001 (2) (Records):

⁸³ See Tr 90.

⁸⁴ Note, too, that the Final Investigation Report acknowledges that the company "purged" Ms. Bates's emails, indicating this was a matter of routine upon employee termination. See Exhibit C-1, page 9.

A. Each utility shall keep its books of accounts, and all other books, records and memoranda which support the entries in such books of account so as to be able to furnish readily full information as to any item included in any account. Each entry shall be supported by such detailed information as well as permit ready identification, analysis, and verification of all facts relevant thereto.

B. The books and records referred to herein include not only accounting records in a limited technical sense, but all other records, such as minute books, stock books, reports, correspondence, memoranda, etc., which may be useful in developing the history of or facts regarding any transaction.

Should Staff have any concerns that the company is not appropriately identifying and producing books and records responsive to Staff requests, Staff should immediately bring its concern to the Commission's attention.

VI.

CONCLUSION

For the reasons set forth above, this PFD recommends that the Commission:

1. Find that Detroit Edison violated the restoration tracker provisions of the December 23, 2008 order in Case No. U-15244 by failing to seek prior approval of its change in classification of certain expenses from the restoration tracker to the line clearance tracker;
2. Find that Detroit Edison failed to adopt reasonable accounting procedures that would prevent the double-capitalization of restoration costs;
3. Find that Detroit Edison made an arbitrary change to its line clearance expense capitalization method to increase expenses assigned to the line clearance tracker;

4. Find that Detroit Edison failed to adopt reasonable accounting procedures that would prevent the double-expensing of costs associated with joint use “Work as a Contractor”, and that Detroit Edison did double-book such expenses during 2008, resulting in a correcting journal entry for 2008 of \$3.9 million;

5. Find that Detroit Edison likely booked joint use “Work as a Contractor” revenues to Other Income and Deductions (OID) but did not book corresponding expenses;

6. Direct Detroit Edison to take the following remedial measures:

a. Adopt Staff’s proposed remedial action to address accounting deficiencies leading to Detroit Edison’s potential double-capitalization of restoration expenses, including filing a report to the Commission in this docket within 90 days identifying and documenting the implementation of any changed accounting procedures and improved internal controls;

b. File, either in this docket or separately, an application for Commission approval of a method for determining the amount of line clearance costs that should be capitalized. Include with the filing a review of actual and planned pole top maintenance work for the period 2008 to 2012, stated on a comparable basis.

c. File in this docket the report anticipated by Staff establishing that its Work as a Contractor expenses flow through to OID;

7. Impose a condition on the line clearance tracker parallel to the restoration tracker, requiring Detroit Edison to seek Commission approval for changes in its accounting methods related to the tracker.

8. Caution Detroit Edison to ensure that its books and records are maintained in accordance with applicable standards, and that it is responsible for ensuring that overzealous employees do not thwart Staff access to books and records.

9. Conclude that the Commission can address any impact of Detroit Edison's accounting changes on tracker cost recovery or rates in Case No. U-16246 or a subsequent reconciliation docket, and/or in the company's rate cases as relevant.

STATE OFFICE OF ADMINISTRATIVE
HEARINGS AND RULES
For the Michigan Public Service Commission

Sharon L. Feldman
Administrative Law Judge

Issued and Served: December 6, 2010
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